$50.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

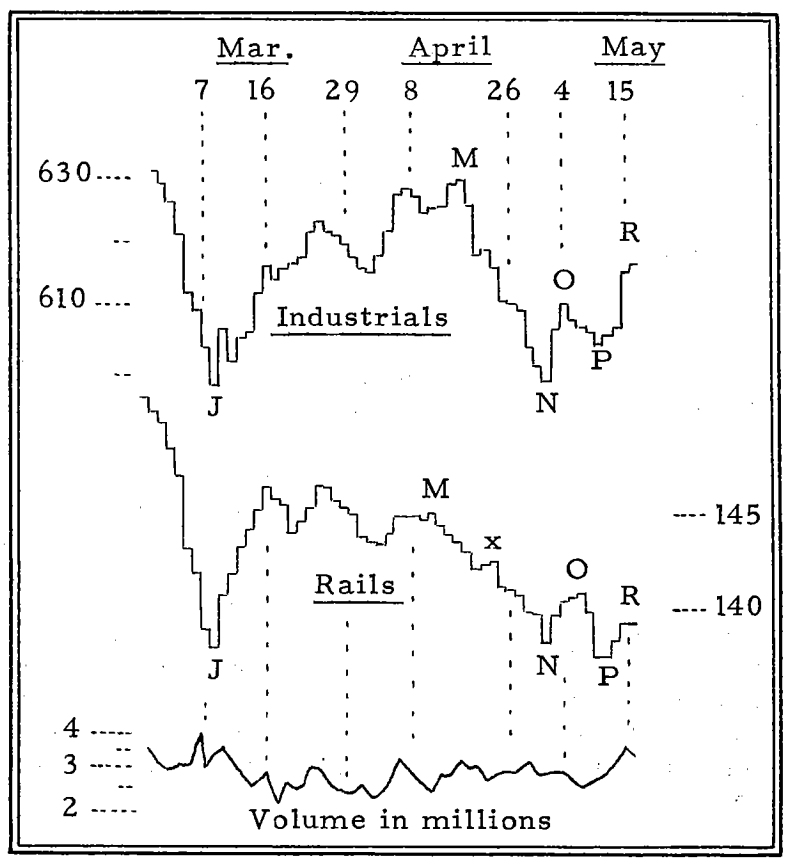
RICHARD RUSSELL
125 East 93rd Street
New York City 28

Registered with the Securities and Exchange Commission
All Rights Reserved

NEWS. In a recent Letter I mentioned that good news has a habit of appearing during bear market rallies. Over the last few weeks we heard that auto sales have picked up, retail sales are booming, employment is up, unemployment is down and consumers are in a "buying" mood. Since all this is undeniably true, bulls are wondering why the market does not turn around and start marching back over the 1959-60 highs. The answer is that the market is concerned only with the future, while fundamental statistics are all part of the past. The aforementioned facts were known by the market and were thoroughly discounted and built into the price structure, days, weeks or even months ahead of the announcements.

Dow's Theory is based on the ability of the Averages to render their decision well ahead of any current statistical evidence. The reason for this is that informed investors tend to swap stocks for cash when business is near, but not yet at, a major downturn. Conversely, when knowledgeable investors judging from what they know of their own businesses and general conditions, foresee an upturn, they begin accumulating stock for the rise. The public, on the other hand, concerns itself only with the past and the present, and it can never seem to comprehend a market that rallies despite bleak financial headlines or breaks in the face of a flood of good news.

THE MARKET Following the most recent lows at N (see chart), both Averages rallied sharply to 0. From there Rails broke to a new bear market low at P (137.68); Industrials, however, would not confirm the Rail weakness (Industrials would not violate their corresponding low point at N). This led to another rally on expanded volume. The rally succeeded in taking Industrials above their preceding peak at 0, but here Rails refused (1) to confirm the Industrials' strength by bettering 0, (2) to advance even percentage-wise as fast as Industrials. This gives us the current uncertain picture of an upward zig-zag in Industrials (N-O-P-R) and a downward zig-zag in Rails (M-N-O-P).



On May 13 (Friday), as Industrials bettered their preceding peak at point 0, volume rose to the highest level in over two months. This high volume (3.75 million shares) would have been impressive if Rails had also confirmed the move by bettering point 0. As it was, however, the volume might well have been viewed with suspicion. When preceding points are approached on high volume, and one or both Averages fail

to better the preceding points (despite the high volume), there is always the strong possibility that the market is "churning" (stocks are being distributed).

As mentioned many times before, stocks in one Average are often distributed under the guise of strength in the other. If Rails were distributed on the high-volume P-R advance, then there will be trouble ahead, and the Industrial rally will be a short-lived affair. If, on the other hand, Rails were being accumulated, they should shortly be able to better their preceding peak at 0.

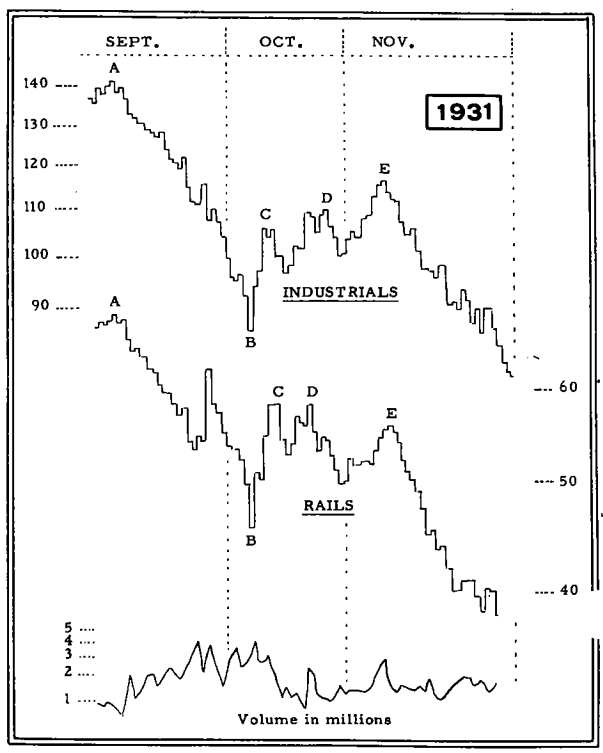
A Rail bettering first of point 0 (140.85) then of point x (142.38) could provide enough technical strength to take Industrials to or above their April high at M (630.77). Conversely, if current Rail weakness is "tipping" the true undercurrent of the market, a violation of the bear market lows (Industrials at N -- 599.10, Rails at P -- 137.68) is sure to occur. Such a joint penetration would signify that the third leg of the bear market was underway.

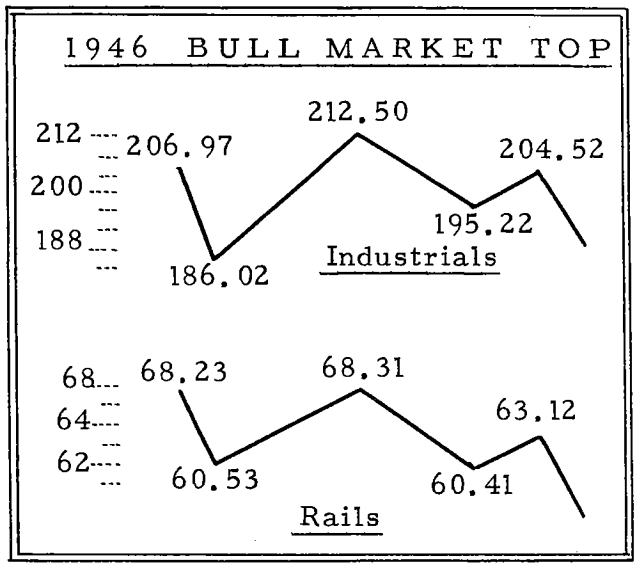
Because Industrials have twice approached the March 8 lows and refused each time to break through, market analysts are proclaiming a "triple-bottom". Personally, I never put too much credence in "double" and "triple" bottoms or tops. They are usually recognized after the event and are generally more deceptive than useful.

It was interesting to observe Wall Street's reaction to the recent news of the U-2 plane fiasco and the Eisenhower-Khrushchev summit explosion. The market's first response seemed to be that the new turn of events was bullish (a renewal of the defense build-up). I suggest, at this point, that readers study Rhea's words, written in March, 1936, "...the first response of the market to unexpected news is usually the reverse of the direction which prices will soon travel."

BEAR ANATOMY. The writer's article on bear market reactions appears in the current issue of Barron's. As a footnote to the article, I have drawn a chart of a classic bear market reaction which occurred in late 1931. The 1931 price movements provide a remarkable comparison with the current typical bear structure in the Averages.

Note the long primary (bear) swing from A to B on the 1931 chart. This might correspond to the present January-March leg. Note also the numerous violent one-day rallies which punctuated the 1931 swing (A-B). From B a sharp "bouncing" rally (from no apparent base) took the Averages from B to C. Following C the Industrials built a rather impressive series of ascending zig-zags with successive peaks at D and E. But Rails hit their high at D and refused to confirm the subsequent highs in the Industrial Average. At E the Averages made their final surge to the accompaniment of a great increase in volume, but a good deal of steam was being expended under the market boiler and still the Rails had not confirmed. Subsequent to the dangerous looking pattern at E, both Averages turned down and violated preceding minor decline lows. As the B points were again approached the movement of the Industrials became erratic, but the downward force proved too powerful, and both Averages plunged through the lows. This joint penetration signified that a new primary leg (starting at E for Industrials, D for Rails) was underway





QUESTION. What constitutes penetration under the Dow Theory?

ANSWER. A penetration is a movement of an Average through a previous point by an amount of one cent or more. There are some who claim that a percentage penetration such as 1% or 3% should be used or that only a full point (one dollar) is significant. Hamilton and Rhea both used the one cent rule as regards penetration. Rhea also felt that increased volume added authority to a penetration.

In 1934 Rhea stated that "...in many years of trading on the implications of the Averages, I prefer to see critical points penetrated with accelerated velocity. I give some weight in personal trading operations to this factor, and to simultaneity (both Averages penetrating on the same day) rather than extent. For instance, after a secondary reaction in a bull market, when prices again approach a previous critical high point, but shortly before reaching that barrier, recede for perhaps a week with diminishing activity, then, if the volume increases as the critical hurdle is approached and passed, I would feel much more disposed to follow the movement than would have been the case had the Averages pushed through the critical point on sluggish action following a long uninterrupted advance."

The 1946 bull market top (see chart) provided one of the most fascinating test cases of the one cent penetration principle in market history. In early February, 1946, the two Averages hit highs of 206.97 (Industrials) and 68.23 (Rails) respectively. A secondary reaction followed which by late February had bottomed out at 186.02 and 60.53. A new advance ensued, and since the market was then in its third phase, Dow Theorists were watching to see whether both Averages could better their previous highs and thus reconfirm the bull market. Industrials hit 212.50 on May 29 and Rails on June 13 finally bettered their earlier peak by a scant 8¢ (68.31)! To those who took any penetration as valid, the 8¢ Rail penetration meant that the bull market was reconfirmed. It also meant that the previous secondary lows had no further significance. BUT -- to those who demanded a full dollar for a valid penetration, the new Rail high had to be considered false, and the preceding lows of 186.02 and 60.53 still held as the true secondary lows. A violation of those lows, of course, would mean confirmation of a bear market.

Immediately following the new May-June highs, another reaction developed and this time the Averages stopped at 195.22 and 60.41. From these new secondary lows an advance began, and again Dow Theorists watched to see whether the highs would be bettered. This advance fizzled at 204.52 and 63.12. Dow Theorists who accepted the 212.50 high and the 68.31 Rail high as valid now watched the 195.22 and 60.41 lows as the bear signal points. But those who did not accept the 8¢ Rail penetration still had to consider the 186.02 and 60.53 figures as the bear points.

On August 27 the 195.22 and 60.41 lows were shattered and the 1¢ penetration school called a bear market (and presumably sold whatever stocks they still held). Those who demanded a one dollar penetration sold a few days later at 186.02 for a rather ironic loss of 9.20 points on the D-J Industrials (equal to 27 points today)!

BARRON'S CONFIDENCE INDEX. This week's reading of the C.I. shows a plunge to a new low of 79.9, a drop of 1.6 points from the preceding week and the biggest drop of the year. The rate of decline in the C.I. has been accelerating over the last few weeks, and this would indicate either (1) an impressive primary bear leg extending at least into July, 1960, or (2) the end of the C.I. as a valid technical aid.

CANADA. In the last Letter I mentioned a different kind of margin call, one which could occur during a protracted slump. Canada is now subject to another pressure which has long been on the minds of market observers. I quote from a recent article in the N.Y. Herald Tribune: "With the Canadian stock markets sliding, the eight (mutual) funds that are members of the Committee of Canadian Investment Companies have found their redemptions outstripping sales." The explanation is given as follows: "Fund people up North say that Americans expected too much from Canada's growing economy. The U.S. Investor, in their view, was looking for one big boom camp with gold mines in every cellar and oil wells gurgling through every gutter -- all to the background of wildly ticking geiger counters, of course."

CHARTS. In answer to many inquiries, I use charts of the daily and weekly price movement in suggesting stocks to buy and sell. These charts are sent to me by friends at Microstat Corp., 70 Pine Street, N.Y.C. The charts are actually on microfilm and all stocks listed on the N.Y. Stock Exchange are reviewed by the writer each week. Golds have recently turned weak, and although Campbell and Dome were suggested several months ago, both of these have now broken nearby support points and now look unattractive. American Cyanamid and Heyden-Newport have reversed to the upside, and although I would not buy them, I would cover shorts.

Oil weakness (discussed in Letter 102) has now become painfully apparent. Texaco, last holdout in the Internationals, broke its support and joins the list of shorts. The machinery group continues to act weaker than the market. National Acme, recommended as a short at 48 has cracked. Gardner Denver has just broken all important support and can be shorted. Caterpillar Tractor broke at 29 and may be shorted as close to that figure as possible. Babcock & Wilcox would be a short at a closing of 32.

TREASURY BILLS. This week's issue of 91 day Treasury bills sold at an average yield of 3.79%, up a whopping half-percent from last week. Again the money market has confounded those who felt that if stocks go down, money has to ease (see Letter 101). I had written a few weeks ago that I was buying bills on a 30-day open market basis. As of now, bills can again be purchased at attractive yields, and I am doing so.

(Written Tuesday, May 17th, before the close.)